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THE PSYCHIC COSTS OF TAX COMPLIANCE:  
NATURE AND IMPLICATIONS FOR POLICY

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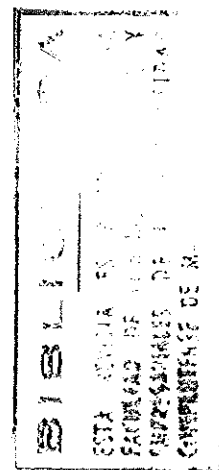
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Tim AUBURN and Peter PIERPOINT

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ABSTRACT

A major principle of tax law is that taxes should be equitable in the demands demands that they place upon the section of the population at which they are aimed. It has been increasingly recognised, however, that the costs incurred over and above the revenue paid to the authorities, as a consequence of compliance with tax law are the significant way in which inequity in the application of taxes comes about. Strong economic cases have been made for the inclusion of such compliance costs as an argument in the tax policy function.

Compliance costs have been regarded as having three components: financial (e.g. paying a third party to deal with one's tax affairs), time (e.g. that spent in completing a tax return) and 'psychic'. The financial and time components have been researched for more than fifty years. However, as the state of knowledge about these components of compliance costs has grown so the psychological component has been increasingly neglected. This neglect does not arise from a suggestion that 'psychic' costs are unimportant (the opposite case has been made), but rather from a pessimism about the practical means available for their measurement.

From an examination of the fiscal literature on 'psychic' costs two main factors emerge: an anxiety factor and a resentment factor. Both of these factors constitute negative emotional responses to the fiscal environment of the individual taxpayer. Furthermore, this examination suggests that the application of psychological models and psychological scaling and measurement techniques can go a considerable way toward elaborating the nature of 'psychic' costs.

A definition of 'psychic' costs is proposed and a model of their incurrence is presented. This definition and model draw upon well-established psychological theory and knowledge. The definition of 'psychic' costs has three components. Firstly, the manifestation of 'psychic' costs is regarded as a set of negative emotional responses with anxiety and resentment being the major responses. Secondly, these negative emotional responses are considered to be structured by an interaction between imposed tax requirements and the individual's cognitive framework through which the external world is experienced and interpreted. Thirdly, compliance is regarded as involving a number of decisions for the individual about what course of action to take. These decisions are conceptualised as ones between competing end goals and are characterised as involving avoidance-avoidance and approach-avoidance conflicts.

This definition also suggests a model of how 'psychic' costs are incurred. We have initially proposed a two stage model. The first stage is one where the decision to comply is made and a subsequent stage where compliance is enacted. Both these stages are regarded as ones fraught with decisional conflict where the individual has to bring his knowledge of taxation and other relevant facets of his cognitive framework to bear upon the problem and where the outcome for the individual is a range of negative emotional responses.

On the basis of this definition and model of 'psychic' costs a research programme is proposed which has three objectives:

- (i) to establish the nature of the psychological component of compliance costs and the magnitude of these costs;
- (ii) to identify those factors which predict the degree of 'psychic' costs incurred by the individual;
- (iii) to examine the distribution of 'psychic' costs amongst different social groups and business sectors.

Two independent, but conceptually related, studies are proposed. The first would examine 'psychic' costs among personal income tax payers and the second would examine 'psychic' costs among people in small businesses who pay value added tax. These two groups would be chosen for investigation for two main reasons: firstly, both income tax and value added tax are widely incurred taxes which affect a large proportion of the population, and secondly, we have assumed that 'psychic' costs, although sharing a common etiology, will differ in content and the relative weighting of the different components depending upon the nature and purposes of the tax. The research strategy would be a mailed questionnaire survey of 4000 personal income tax payers and 1000 small businesses. Two questionnaires would be developed; one appropriate to each sample. However, both questionnaires would have a common focus and would contain questions in the following areas: demographic characteristics, ratings of anxiety and stress, perceived consequences of compliance and evasion of tax, the 'image' of the tax authorities, knowledge of taxation, the social and moral framework of taxation, the amount of effort put into dealing with tax, the range of emotions felt by the individual at different stages in compliance. Analysis of the results would be by descriptive statistics, inferential statistics and multivariate statistics.

Such a study, as is proposed, would form an important complement to other work being conducted, particularly by the Centre for Fiscal Studies at Bath University, with respect to tax compliance costs. The significant and unique aspect of this study is that it recognises the fundamental importance of the 'psychic' element of tax compliance neglected, as it has been, for far too long. This element has been a seriously neglected area of study by fiscal analysts. This proposal constitutes a major development in the study of tax compliance costs and will supply tax policy makers with a mechanism of integrations in psychic costs of compliance as an explicit argument in the tax policy function.





THE PSYCHIC COSTS OF TAX COMPLIANCE:  
NATURE AND IMPLICATIONS FOR POLICY

DEFINING PSYCHIC COSTS OF TAX COMPLIANCE

The compliance costs of taxation have been defined as:

'those costs incurred by taxpayers or third parties in complying with a tax, or tax system, over and above, the revenue paid to the authorities and, over and above, any costs of distortion arising from the tax' (Sandford (1981)).

Such costs may take the form of financial commitments to specialist staff and their associated resources, of time costs associated with form filling and finally with 'psychic' or 'psychological' costs. Such 'psychic' costs are very much the neglected element in the compliance cost trinity.

Compliance costs in general and the 'psychic' element in particular have, until fairly recently, been overlooked by tax policy makers and administrators although some economists have recognised their import.

Montesquieu (1748) noted the resentment caused by the tax gatherer 'rummaging and searching' in the homes of taxpayer and arguing that 'nothing is more contrary than this to liberty'. Later, Mill (1848) stressed the fact that privacy was invaded by certain taxes such as income tax, as the tax gatherer 'exposed ones genteel poverty'.

Primarily though it is to Adam Smith (1776) that one turns for a wide ranging discussion. Three of Smith's four maxims of taxation are, according to Sandford (1986), concerned wholly or partly with compliance costs. We would go further and argue that these three maxims, two, three and four are concerned clearly with the 'psychic' costs of compliance.

Smith's second maxim argues:

'The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person'.

Such will ensure that the tax payer is not then thrust into 'the power of the tax-gatherer'.

Clearly, the uncertainty that can be created and the feelings of helplessness could be argued to be 'psychic costs'.

Smith's third maxim states:

'Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it'

Again, feelings of 'inconvenience' associated with tax compliance may generate some kind of resistance and resentment. These are the negative emotional feelings of 'psychic' cost.

Smith's fourth maxim contains a clear statement of certain other 'psychic' elements of compliance costs:

'by subjecting the people to frequent visits, and the odious examination of the tax gatherers, it may expose them to such unnecessary trouble, vexation and oppression, and though vexation is not, strictly speaking, expence, it is certainly equivalent to the expence of which every man would be willing to redeem himself from it'.

Further, Smith refers to the 'insolence' and 'oppression' of the tax gatherer being more burdensome than the tax itself.

Clearly, the 'psychic' cost of compliance is a multi-faceted notion reflecting the many different characteristics that are felt to be important. The uncertainty, powerlessness, inconvenience, trouble, vexation and oppression are certainly feelings that we might well wish to be without. Such feelings can be classified into two sub-species of 'psychic' cost.

Firstly, there is a factor that one might refer to as 'anxiety' (stress, fear and uncertainty), and secondly, a factor that we might refer to as 'resentment' (invasion of privacy, inconvenience, trouble, vexation and oppression). Both of these factors are negative emotional responses to the particular fiscal environment that the taxpayer inhabits. The nature and genesis of these negative emotional responses is the focus of this research proposal.

The Meade Committee's (1978) definition reflects this kind of division when offering the following view of 'psychic' costs of tax compliance:

'the worry and anxiety which tax affairs do cause people. These are almost impossible to value although they may be very real, especially for the retired, for persons with marital problems (eg. separated or divorced persons) and for widows whose husbands have always filled in tax returns'.

#### STUDIES OF TAX COMPLIANCE COSTS

The financial and time costs associated with tax compliance have been the subject of empirical study for more than fifty years (Haig (1935)). Early studies related to the corporate sector, particularly in the USA, and it was only in the 1960's that studies of individual tax payers began.

However, as late as 1973 Sandford was able to claim that the issue of compliance of individual tax-payers was 'a territory so virgin', offering his work as a 'basepoint for other researchers'. More recently though, within the

last decade, a number of studies of tax compliance have been undertaken with increasing support by governments. Sandford (1986) writes:

'Recent independent studies undertaken at the Bath Centre for Fiscal Studies have had the full co-operation of Customs and Excise and the Inland Revenue, and been blessed by Treasury ministers. Most recently, a consortium, consisting of the Economic and Social Research Council, the Treasury, Inland Revenue and Customs and Excise, has funded a further research project at Bath which would up-date earlier studies and enable an estimate to be made of the costs of operating the whole UK tax system. Finally, the UK government, in the White Paper, Lifting the Burdens on Business, has given explicit recognition to the need to reduce compliance costs for small businesses'.

One notable feature of the work done in the domain of compliance costs has been the increasing neglect of the psychological element. The 'psychic' or 'psychological' element of tax compliance is acknowledged as being real and important but generally it is argued that although such costs are in principle measurable in practice they may be almost impossible to evaluate.

The view of Sandford reflects this position:

'Psychic costs are in principle measurable. But it is very difficult to obtain any meaningful value for them and for practical purposes it may be as well to omit them from the measurable costs, though not from the total tally of compliance costs'. (Sandford (1973)).

This pessimism concerning the ability to obtain a measure of 'psychic' costs may well be somewhat misplaced and premature. The application of certain conceptual models and research strategies developed within the psychological sciences would be of considerable utility in the evaluation and assessment of psychic costs.

#### TOWARDS AN OPERATIONAL DEFINITION OF PSYCHIC COSTS

Any definition of 'psychic' costs should fulfil two broad criteria. Firstly, it should relate to the concerns expressed by those in the field of fiscal studies. Secondly, it should be stated in such a way as to be conceptually valid from a psychological perspective and thus amenable to empirical inquiry. As an initial attempt to define psychic costs, we propose the following:

Psychic costs are those negative affective responses arising from the personal and social interpretive framework that the individual applies to the decision to comply with taxation law.

There are three essential characteristics of this definition. First, 'psychic' costs have been equated with negative affect. This approach captures the broad consensus of those in the field of fiscal studies that 'psychic' costs are synonymous with a related set of unpleasant emotions - worry, anxiety and resentment (Sandford (1973), Sandford (1979)). Moreover, from a psychological perspective, it provides an initial framework for the application of a model which explains the causes of negative effect. There has been increasing attention paid to stressors which are small scale but form part of the quotidian round. These types of stressors have been referred to as 'daily hassles' (Lazarus and Cohen (1977)) or 'ambient stressors' (Campbell (1983)). The negative affect arising from tax compliance can be regarded as falling into this category of stressor. Given that tax compliance can be regarded as an 'ambient stressor' this implies that costs are incurred as a consequence of the deployment of mental resources by the person in order to cope with the demand placed upon them by the stressor.

Central also to this component of the definition of 'psychic' costs is the notion of anxiety as one of the major responses to stressors. Anxiety is most commonly defined as an unpleasant, consciously-perceived feeling of fear, apprehension and tension, an emotional response to a threatening future event; it is also often accompanied by an increased degree of physiological arousal (Davison and Neale (1982)).

This definition of anxiety is a broad one and consequently many researchers in this area have felt that it incorporates too wide a range of affective phenomena. Thus attempts have been made to distinguish various more specific

types of anxiety. For example, one widely accepted distinction is that between trait-anxiety, referring to individual differences in anxiety proneness, and state-anxiety, referring to an emotional reaction to a specific event. A further distinction under the general category of state-anxiety is that of test anxiety (Sarason (1980)) which refers to the anxiety provoked by test situations such as examinations. Eysenck (1982) suggests that this type of anxiety has two major components: emotionality (a general state of arousal) and worry (concern about the consequences of failure). Test anxiety seems particularly germane to the discussion here, where the mechanisms of compliance with tax law can be regarded as a 'test' with different degrees of penalty for failure. Thus, one of the major negative responses to tax compliance is, we are arguing, test anxiety.

The second feature of our definition of 'psychic' costs is the emphasis upon the interpretive or cognitive framework which the individual employs in the decision to comply. It is not the receipt of say a tax demand itself which structures any emotional experience but the event, in interaction with the individual's beliefs, appraisal of those beliefs and previous experiences, which does so.

This cognitive framework would also include a consideration of the moral orientation of the individual; for example, whether the person was simply complying in order to avoid an unfavourable reaction from some, more or less specifiable group, or had internalised the values associated with voluntary payment of tax (Lewis (1982)). It would also include an evaluation of the rights, duties and obligations which the individual perceives as constituting the social context of paying tax.

This second part of our definition also highlights those factors which

should not be considered as part of the 'psychic' costs of compliance. Sandford (1973) argues that the efforts on the part of an individual to maximise tax avoidance may create 'psychic' costs for those complying with the tax in two ways: by conflicting firstly with the principle of horizontal equity and secondly, with the 'will of parliament'. On our definition 'psychic' costs would not automatically be incurred in this situation. They would, however, if the non tax-avoider was aware of this situation, be perceived as inequitable and be construed as flouting certain moral obligations.

Finally, in our definition, the decisional component of 'psychic' costs is emphasised. A decisional model which incorporates the complementary concepts of approach to, and avoidance of, a goal and the conflict engendered by these competing motives can be applied to explain the development of negative affect. It is not unreasonable to conceive of the decision to comply with tax law as one of conflict between two competing end goals; more specifically, this conflict can be characterised as involving 'avoidance-avoidance' conflict and 'approach-avoidance' conflict (Griffiths (1981)). The 'avoidance-avoidance' conflict is engendered by the person having to make a choice between two unattractive alternatives, here evasion versus compliance. Having made the choice of compliance then execution of this choice is fraught with 'approach-avoidance' conflicts: for example, not being prosecuted for evasion (approach) versus losing money which is perceived as rightfully the property of the individual (avoidance).

## A MODEL OF THE OCCURENCE OF PSYCHIC COSTS

Having adumbrated the three components of our definition of 'psychic' costs, we are now in a position to propose a tentative model which draws out possible linkages between these three elements.

Compliance is conceptualised as a two stage process; one where the initial decision to comply is made and a subsequent one where compliance is enacted. The assumption is made that the majority make a decision to comply and that this decision would be almost automatic or habitual. Nevertheless, this first stage is still one where a decision has to be made to approach an unpleasant goal and, therefore, it might well be expected to produce the negative affect associated with decisional conflict as well as certain strategies intended to delay the choice (e.g. procrastination).

The second stage is perhaps even more complex than the first. Here, the individual has a number of strategies available to him which incur different degrees of cost. For example, low cost strategies might include one where the individual deals quickly and cursorily with his tax affairs, or one where the individual employs a third party to deal with them. On the other hand, greater effort may be invested in the task of compliance if there are perceived benefits, such as reduced tax liability or mitigation of examination and prosecution by the authorities. In addition, the individual is constrained by the framework of tax law which imposes certain duties upon him concerning compliance. The amount of effort and intellectual work invested in the enactment of compliance will be structured by these decisional and interpretive precursors.



## A PROPOSAL FOR RESEARCH

### Purposes

The main purpose of the present proposed research is to use the model outlined above as a broad framework for an empirical inquiry into the psychological structure of compliance costs. We have assumed that 'psychic' costs, although sharing a common etiology, will differ in content and the relative weighting of the different components depending upon the nature and purposes of the tax. For example, the particular beliefs and perceived costs and benefits of compliance with income tax will differ from those of say, value added tax. Thus, we propose to examine the psychological component of compliance with tax law by conducting two independent but conceptually related studies: one of payers of personal income tax, the other would be of payers of value added tax. Although these two taxpaying populations can overlap, our initial focus will be upon the assessment of the 'psychic' costs generated by particular taxes, and thereby, the total 'psychic' costs to the individual as a consequence of all the taxes perceived as being paid. A variety of psychological and demographic variables will be assessed by questionnaire. Through an examination of their interrelationship it should be possible to identify more accurately those factors involved in 'psychic' costs and their interaction. This procedure will enable us to ascertain both the nature of the 'psychic' costs of compliance and their magnitude in relation to other life events.

The second purpose of this study is, through an assessment of these psychological and demographic variables, to identify the predictors of 'psychic' costs. Fulfilling this second purpose will then enable us to pursue a third purpose. Having identified the psychological factors which predict 'psychic' costs then it will be possible to link these factors to demographic characteristics corresponding to broad social groups such as the old, widowed

and divorced. Thus the relative distribution of 'psychic' costs amongst different groups in society can be examined, and hence some conclusions regarding the principles of horizontal and vertical equity and their relationship to 'psychic' costs can be drawn.

The goal of this inquiry would not, in the first instance, be to develop a set of procedural rules for calculating the monetary equivalent of 'psychic' costs. Although this goal may be achievable in the longer term our first priority is to examine the structure of the psychological component of compliance costs and the way that these costs are socially distributed.

### Overall Design

We propose to conduct two separate studies, each study being a questionnaire survey. The first would be of personal income tax payers and the second of small businesses paying value added tax. Respondents would be approached via a mailed questionnaire. This questionnaire would be designed to examine a number of facets of the psychological components of compliance with tax law.

### Respondents

For each study procedures would be followed to obtain a random stratified sample. In the first study the unit of analysis will be the individual personal tax payer identified through households. In the second study the unit of analysis will be the individual who carries the sole, or main, responsibility for tax affairs within the small business. For the first study a national sample of 4000 plus would be obtained by following multi-stage sampling procedures (Moser and Kalton, (1971)) with prior stratification made on the basis of area. After data collection, further post-stratification of the sample would be made on the basis of other demographic characteristics, viz. age, marital status and income, complexity of tax affairs.

For the second study we would co-operate with the Small Business Research Trust in identifying a sample of small businesses of 1000. Again, a stratified random sample could be identified with the relevant strata being sector of business and size of business.

#### Staff

The staff working on the project would include the two applicants and a research assistant who would be employed full-time throughout the term of the project. The research assistant would be expected to have a good first degree (2i or better) in Psychology and/or Economics. The research assistant would also be expected to have some knowledge of survey methodology. Whilst in employment the research assistant would be expected to undertake courses provided by the institution on data handling and data analysis on the mainframe computer. In addition, the research assistant would have the opportunity to undertake some small amount of teaching and/or tutorial work.

The applicants would be jointly responsible for the following: overseeing the development of the questionnaire, devising the sampling plan, overseeing the distribution of the questionnaire, guiding statistical analysis and writing up results and the final report. In addition, the applicants would conduct literature searches in their respective areas of expertise and be jointly responsible for the dissemination of the work through presentation of conference papers and the writing of papers to be submitted in both academic and professional journals.

The research assistant would be responsible for the day-to-day work of the project; in particular, organising the printing and distribution of the questionnaires, following up non-responses, coding the data in a form suitable for input to the computer, running the analyses and helping with the interpretation and presentation of the results.

It is anticipated that part-time assistance will be employed on return of the questionnaires to ease the 'peak load' problems associated with encoding data.

#### Procedure

Having identified the two samples the cases in each sample would be sent a questionnaire and asked to complete and return it. In those cases where no reply is received follow-up 'reminder' letters will be sent out at appropriate intervals.

The nature of this research suggests that special arrangements should be made to maintain the confidentiality of the participants. In addition, if these arrangements are made explicit to the participants then the response rate should be maximised. The arrangements to maintain confidentiality will take two forms. First, the usual assurances will be clearly stated: the information collected from the survey will not be used to identify any individual nor will the survey data be made available to anyone in a form which will enable them to identify any individual. Second, each sample case will be allocated a code number which will allow the researchers to identify them. This code will be stamped at one corner of the first page of the questionnaire. The respondent then has the option of removing this code. This option will guarantee the respondents' anonymity if taken up.

#### Materials

Two standard questionnaires would be developed, one questionnaire for each sample. It is anticipated that this development would require intensive piloting work, involving a small number of face-to-face interviews and a larger number of mailed questionnaires. This piloting phase would be conducted on accidental samples obtained in the South-West area; moreover some attempt would be made to maintain quotas of respondents in relevant classes.

In addition to an assessment of demographic characteristics, it is anticipated that the questionnaires would contain the following sections:

- (a) An assessment of the level of anxiety engendered by different facets of tax affairs. This assessment would require overall a rating of anxiety, a rating of the symptoms of anxiety and a ranking of tax affairs in relation to other stressful life events.
- (b) An assessment of the perceived consequences of the decision to comply or evade tax laws and an evaluation of these for their likelihood. This section would attempt to assess the degree of 'avoidance-avoidance' and 'approach-avoidance' conflict inherent in decision making about tax affairs.
- (c) An evaluation of the 'image' of tax authorities and of the person's previous experiences with the tax authorities.
- (d) An assessment of the person's knowledge of tax affairs and his/her perception of his/her own degree of understanding of tax affairs.
- (e) An assessment of the person's perception of the social and moral framework in which tax affairs are couched. This section would include an assessment of the subjective norms that the individual utilises in his decision about tax affairs.
- (f) An assessment of the amount of intellectual resources which the individual invests in dealing with his tax affairs.
- (g) An assessment of the range of emotions felt by an individual at various points in the execution of compliance.

Where possible extant psychological questionnaires will be used principally because they will have been tested for reliability and validity.

### Analysis of Results

Multivariate statistical analyses will be carried out. In the first stage of analysis descriptive and inferential statistics will be used to analyse the data. Factor analysis and hierarchical cluster analysis will then be applied to the questionnaire data. These analyses should go much of the way toward revealing the psychological structure of 'psychic' costs of compliance and give some indication of their magnitude both overall and for different social groups. The second stage will be concerned with identifying those factors which predict the degree of negative affect experienced by the individual taxpayer. In order to achieve this goal regression analysis will be conducted. However, more complex modelling analyses could be performed such as path analysis.

### Anticipated Outcomes

In itself this proposal is relatively small scale and only begins to address the issues surrounding the psychological component of compliance costs. However, there are a number of outcomes anticipated from this research which would be of wider benefit. First, it will contribute usefully to the debate on tax policy. Whereas, at present, recommendations about tax policy are made, either without reference to 'psychic' costs or on the basis of unsubstantiated assumptions about them, this research will enable policy recommendations to be made on the basis of empirical evidence about the nature, magnitude and distribution of 'psychic' costs. In particular, this study will complement the work being undertaken at the Centre for Fiscal Studies at Bath University.

Second, this research will be of help to those organisations which traditionally take some of the burden of compliance costs, such as accountants or the Citizens' Advice Bureau. If these organisations can understand more about the 'psychic' costs incurred by their clients and which groups are most vulnerable then they will be in a position to gear their organisation more closely to the needs of their clients.

Third, we would anticipate that dissemination of this research would occur through papers submitted to a range of journals, both academic and professional, and by presentation at conferences.

Finally, the outcome of this research would indicate areas and direction in which future research could be taken. At present, two particular directions can be anticipated: the 'psychic' costs of different taxes such as inheritance tax and an investigation of the structure of compliance costs as a whole by further examining the relationship between the 'psychic', time and money costs of compliance. One further direction, but one which would require a large investment of research effort would be to examine the relationship, if any, between compliance costs and tax evasion.

Overall, this proposal addresses an issue which has been neglected for too long a period. By employing concepts and techniques which lie at the interface between economics and psychology we feel progress can be made toward successfully understanding and resolving it.





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